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The general perception that the U.S. economy is in relatively good shape reflects a kind of revolution in what Americans expect of their economy — a revolution of falling expectations. Americans once expected their economy to deliver steadily rising standards of living, with each generation markedly better off than its parents. At the start of the 1990s, however, we seem content with an economy that gives us living standards that creep up slowly, if at all.

— Paul Krugman, *The Age of Diminished Expectations*, 1990

ON CLOSER LOOK

Entering the new year, we all are pondering what it will bring personally, politically, economically, financially and so on. Economics and finance is the subject of this letter. A year of strong and widespread economic growth lies behind us, which had its primary propellant in unusually aggressive U.S. monetary and fiscal policies. What will the new year bring after these policies have spent their force?

Last year seems to have seen the fastest economic growth for almost three decades. What now? The perceived wisdom is that global economic growth will continue to be strong, though at a somewhat slower pace, while inflation rates for goods and services are supposed to change very little.

As in 2004, the U.S. economy and emerging Asia are marked to be the star performers in 2005. Very different institutions, national and international, have all forecast 3.5% real GDP growth for the United States. That is less than last year, but still above trend. Underpinning the general optimism apparently is the general expectation that business fixed investment will take over from consumption as the driver of U.S. economic growth.

The Federal Reserve is on record with a most optimistic forecast. In its Federal Open Market Committee (FOMC) minutes of Dec. 13, it has set out its two main optimistic assumptions: First, *increasing equity and home prices have boosted household net worth, leaving consumers well positioned to maintain a brisk pace of spending; and* second*, many of the fundamentals underlying the demand for capital goods — expanding output, a low cost of capital, strong profits and ample liquid assets — appear quite favorable.* In other words: more of the same good things as in 2004.

Reading many U.S. forecasts, it strikes us that virtually none mentions any of the huge imbalances that have accumulated in the economy over several years of unprecedented credit excess, some of which are sure to impair future economic growth.

The apparent general assumption is that none matter: neither the record-high and still soaring trade deficit, nor the gargantuan and still soaring debt levels of private households, nor collapsed national and personal savings, nor grossly inflated stock and house prices.

In our view, the greatest and most unpleasant surprise in 2005 will be the U.S. economy's sudden pronounced and protracted weakness. Basic to this assumption are mainly two observations:* First*, the massive monetary and fiscal stimulus of the past three years has spent its force and flatly failed to generate sufficient traction in business investment, employment and income growth; and* second*, the bubble-driven consumer borrowing and spending binge is prone to weaken.

The official final estimate of Q3 real GDP growth is 4%, up from Q2's 3.3%. But this acceleration had its main cause in a vertical plunge of the GDP deflator to 1.4% at annual rate, after 3.2% in the prior quarter. In other words,

almost half of the reported higher real GDP growth came from the steeply lower deflator, rather than from higher spending. Fortunately, a sharply lower deflator also translates statistically into equally higher productivity growth.

For the 12-month period ended in December 2004, the CPI has risen 3.3%, as against 1.9% in 2003. Wisely guided by the Fed, all the talk in the media is about the "core rate of inflation," minus the "volatile" oil price, running at around 2%. In the conventional forecasts for 2005, the U.S. inflation rate averages 2.2%.

While the Fed has meanwhile hiked its interest rate from 1% to 2.25%, the CPI is up 1.5 percentage points. Real, or inflation-adjusted, long-term interest rates have even declined to new record lows.

Yet we would not take those rate hikes too lightly, given the Fed's strong public commitment to continue them. Rising rates at the short end of the market will gradually undermine the asset and credit bubbles. Given a financial system that, in absence of any internal savings, depends entirely on highly leveraged carry trade, it seems appropriate to regard the whole U.S. economy as a grand hedge fund. These temporarily prosper on a steep yield curve and asset bubbles. Emphasis is on "temporarily."

Unfortunately, the conventional forecasts completely fail to address the most important question of all for the bubble economies, of which the U.S. economy is one. What will happen to the asset bubbles? As to the U.S. stock market, bullish sentiment is off the charts. But keep in mind that mere failure of asset prices to rise further is enough to rob them of their positive effects on the economy.

DIFFERENT INFLATION EFFECTS

In its Jan. 10 issue, *BusinessWeek* carried an article titled "A Gold Medal for the Fed's Inflation Fighters" from Glenn Hubbard, dean of Columbia Business School and former chief of the president's Council of Economic Advisers. The key point of this article is that *"by holding inflation down, the Fed has boosted the economy."* We mention this article because it is highly typical of the prevailing systematic disinformation about the U.S. economy.

Given a U.S. inflation rate of 3.3% during 2004, any talk of *"ridding the U.S. economy of inflation"* is, first of all, grossly misplaced. Even more absurd is the further assumption that the Federal Reserve has distinguished itself as a great inflation fighter.

In actual fact, in the past few years, the Alan Greenspan Fed has systematically and deliberately fostered parabolic credit and financial excess with the explicit purpose of inflating asset prices. What manifestly is duping most people is the fact that the bulk of the credit excess poured into asset prices and the soaring trade deficit, rather than into the CPI, as had been usual.

As we have repeatedly stressed, speaking of inflation requires first of all a distinction between cause and effects. It ordinarily has one and the same cause: excessive creation of money and credit. But its impact on the economy and its price system depends entirely on the specific purposes for which the borrowed money is used. Therefore, its effects may differ immensely.

Principally, credit excess may find three different outlets:* first*, rising prices of goods and services;* second*, rising prices of financial and tangible assets; and* third*, a rising trade deficit.

The conventional focus is exclusively on the first outlet: that is, on the movement of consumer prices, popularly called CPI in America. Amazingly, even most experts flatly deny a causal connection between a rampant credit expansion, rising asset prices and a rising trade deficit. The rampant inflation in U.S. stock and house prices is actually hailed as "wealth creation."

Historically, consumer price inflation has, indeed, been the regular key feature of credit excess. But this pattern began to change drastically in the course of the 1980s. For the first time, protracted, exceptionally sharp increases in stock and real estate prices occurred in various countries, while price increases for goods and services remained moderate.

At first, there was little inclination to see in soaring asset prices a feature of inflation, even though all countries concerned showed a simultaneous surge in money and credit growth. It irritated many experts that this monetary explosion did not show in higher prices for goods and labor, as it had done in past booms. In the late 1980s, Japan had double-digit money, credit growth and soaring asset prices, yet virtually stable consumer and producer prices.

For years, this strange coincidence of soaring asset inflation and simultaneous moderate consumer price inflation was hailed as a sign of economic health and dynamism. It has long been one of Mr. Greenspan's favorite arguments that this unusual coincidence proved the existence of a "new paradigm" economy.

While stock prices have recovered from their lows in 2001, in general, their gains during 2004 were very limited. Instead, a developing property bubble has gone global. Full-blown housing bubbles with double-digit annual price increases now exist in many countries, for an obvious cause. Ultra-low interest rates introduced by central banks to fight threatening recession have triggered an explosion in borrowing for house purchases in many countries.

THE KEY FEATURE OF A BUBBLE ECONOMY

Observing this, it must be stressed at the outset that from a macro perspective, the crucial issue is not an asset price bubble per se. The key question is whether and to what extent asset owners convert the asset appreciation into higher borrowing and spending. Asset bubbles as such constitute little more than a temporary economic nuisance.

In France, too, where we live, house prices have soared at double-digit rates. But the key feature of a bubble economy — that is, the run of house owners for equity extraction, as in the United States and Britain — is completely missing, even though variable mortgage rates are at a historical low of 3.25%. Remarkably, nobody in France talks of "wealth creation." France certainly has a house price bubble, but it does not have a "bubble economy" in the sense that the rising house prices are used to boost consumer borrowing and spending for other purposes.

A GLOBAL PROPERTY PRICE BUBBLE

In the late 1990s, the U.S. stock market bubble went global. The same has happened in the last few years to the property price bubble. According to reports, full-blown housing bubbles currently exist in many countries around the world. As explained, their common cause is obvious: Ultra-loose monetary policy and ultra-low interest rates. In due time, sharply rising house prices added to the interest incentive.

Under these monetary conditions, it made sense to buy a house.

But to repeat, the pivotal hallmark of a "bubble economy" is that the ballooning asset prices are widely used as collateral for a general consumer borrowing and spending binge. In the United States, mortgage borrowing by households during the first half of the 1990s increased by an annual average of $168 billion. This accelerated in the decade's second half to $296.9 billion. But after 2000, it virtually exploded to an average annual growth rate of $615 billion.

It is undisputed that the greater part of the escalating mortgage borrowing in the United States was for purposes other than house purchases. In short, it boosted consumption as a share of GDP at the expense of business investment and the trade balance. That is, it radically changed the U.S. economy's pattern of growth — actually an unsustainable pattern of growth.

Yet America's consensus, amongst it Mr. Greenspan and the Fed, categorically refuse to see any proof of a "bubble economy." A recently published survey article by the St. Louis Federal Reserve — "Monetary Policy and Asset Prices: A Look Back at Past U.S. Stock Market Booms" — made a most amazing statement in its conclusion: *"We find little indication that booms were caused by excessive growth of money and credit, though 19th-century booms tended to occur during periods of monetary expansion. The view that monetary authorities can cause asset market speculation by failing to control the use of credit has been largely discarded."*

To quote a commentator: *"The complacency of the central banking fraternity and their academic standard-bearers is a wonder to behold."*

"EXCESSIVE" IN RELATION TO WHAT

Speaking of "credit excess" implicitly raises the question of "excessive relative to what?" For generations of economists of all schools of thought, the answer was an elementary truism. The criterion for "credit excess" or an inflationary credit expansion is available savings. Conceptually, it is the function of interest rates to equilibrate credit growth with available savings.

To quote professor Gottfried Haberler's study "Prosperity and Depression" for the League of Nations in 1937: *"Excessive supply of credit (that is to say, credit creation in excess of 'voluntary savings')… depresses the market or money rate of interest below its equilibrium level; this starts a Wicksellian process which necessarily ends in crisis and depression."*

But what happens when a country has virtually no savings, like the United States? In such a case, credit growth is by definition in its totality "excessive." Since 2000, credit expansion in the United States has been running at an average annual rate of $2.6 trillion, as against near-zero domestic savings.

This is "credit excess" of truly preposterous size. In the first place, it indicates that U.S. interest rates are not only too low; they are absurdly low. But why is this a problem? Such phenomenal credit excess essentially creates damaging imbalances and distortions in the economy, its financial system and its price system, of which two are easily identified in the U.S. case: the gargantuan trade deficit and ludicrously overvalued assets.

In the 1980s, when credit growth sharply escalated in the United States for the first time in relation to simultaneous GDP growth, with very limited impact on consumer price inflation, this caught attention. But few were willing to interpret this as potential inflationary pressures in the asset markets.

For the consensus in the United States, the consumer price index was and still is the one and only relevant gauge of inflationary pressures anywhere in the economy. Plainly, the accelerating credit expansion financed mergers and acquisitions, leveraged buyouts and purchases of real estate. However, rising asset prices were commonly regarded as irrelevant for monetary policy.

As explained earlier, that is true indeed. But they implicitly become a macroeconomic problem when sharply rising asset prices induce a borrowing-and-spending binge, which severely distorts the composition of economic growth. A dangerous "bubble economy" develops when inflating levels of asset prices fuel specific borrowing and spending binges.

By this definition, most countries around the world today have to be classified as "bubble economies." There is but one great exception, and that is the eurozone economy. It has no credit bubbles. Sill, among the bubble economies, there is a crucial difference in the specific use of the credit excess. In the English-speaking countries, the borrowing and spending excesses have been going into residential building and consumption, while in the Asian countries, they are going into business fixed investment and commercial real estate.

MACROECONOMIC THINKING IN ECLIPSE

Recently, the *Financial Times* carried an extensive article from Martin Wolf titled, "Outpaced: Why Are the Eurozone Economies and Japan Doing Worse Than English-Speaking Nations?" Wolf gave four chief answers:

1. The English-speaking countries have not only deregulated their economies significantly but have also made substantial improvements in monetary and fiscal discipline.

2. Their financial systems were extremely well suited to transfer money from savings-surplus to savings deficient households, thereby keeping household saving low and consumption booming.

3. In a world of excess savings, the English-speaking countries had the most creditworthy borrowers.
4. These economies seemed to be relatively good at exploiting the new knowledge-intensive opportunities for higher productivity.

We have quoted Mr. Wolf mainly for two reasons: *First*, the causes of the protracted growth difference between English-speaking countries and Euroland are the most important questions concerning the global economy; and *second*, his arguing is highly typical of conventional Anglo-Saxon economic thinking. A few days later, the London *Times* carried an article with a big headline: *"If Only Europe Followed Our Model."*

To speak of the English-speaking countries as examples of monetary and fiscal discipline is, of course, a great joke. All of them exhibit the key features of a bubble economy even in the extreme: freewheeling credit extension along with inflating asset prices. In addition, budget deficits have soared both in the United States and Britain. What is more, except for Canada, the English-speaking countries are running huge trade deficits, implicitly indicating an excess of domestic spending over domestic output.

We said Mr. Wolf is highly typical of conventional Anglo-Saxon economic thinking. By this, we mean total neglect of major changes in the economy's growth pattern such as collapsing savings, protracted weakness in productive investment and bursting trade deficits. Attention is exclusively on the single number for aggregate GDP growth. By this measure, Euroland's economy has, indeed, for years been underperforming the economies of the English-speaking countries. For the Anglo-Saxon consensus, this essentially reflects bad policies and inefficient economies in Euroland.

For us, it is an unbelievably superficial approach. A most important fact to realize about the recoveries in the English-speaking countries is that their structural pattern is completely out of whack with past recoveries.

The most striking common feature is a virtual collapse of personal and national saving, reflecting unprecedented consumer borrowing and spending binges. As a result, consumption has been absorbing a rising share of GDP at the expense of business fixed investment and foreign trade. Except for Canada, the English-speaking countries have huge and rising trade deficits. For economists with a macro perspective, this is a most deleterious, unsustainable growth pattern in the longer run.

To be precise, this is *current* Anglo-Saxon thinking, differing radically from that in the past. The radical break in economic thinking began in the mid-1990s, apparently ushered in by the booming stock markets. In its wake, general attention shifted away from the economy to the movements of the financial markets.

In public economic discussion, stock market-related analysts and economists have displaced the economists of commercial banks and business corporations. In the 1980s, the only widely known Wall Street economist was my old friend Henry Kaufman, and he was primarily a macro economist, focusing at the time on credit growth relative to the flow of saving.

Today, Wall Street pundits dominate the economic discussion in the United States with their focus primarily on the asset markets. In the past, levels and changes of asset prices were largely viewed as a byproduct of underlying macroeconomic fundamentals. Now these fundamentals have lost any interest. The new predominant belief is that favorable asset markets determine economic activity.

As a result, policymakers, economists and the public in these countries are completely blind to the existing serious macroeconomic maladjustments. Whether collapsing savings, an exploding trade deficit, a surging budget deficit or runaway money and credit growth, nothing matters anymore. It would be an exaggeration to say that macroeconomic thinking is at a low level in the Anglo-Saxon countries. It is nonexistent.

More striking and also more shocking evidence of American macroeconomic neglect for us is in the frenzied emphasis of corporations on mergers, acquisitions, outsourcing and cost cutting as a means to boost profits and

shareholder values in the near term. From the perspective of a single firm, all this may appear reasonable. But from the perspective of the business sector as a whole, it is a worthless activity, adding nothing to economic activity.

The fallacy arises from the fact that these measures are conceived from the perspective of a single firm, completely ignoring major negative effects on firms in the aggregate. Apparently widely unknown, micro and macro perspectives may often drastically conflict. This makes macroeconomic analysis indispensable. Macroeconomics is the study of the economy as a whole; microeconomics is the study of the firm.

It is, in our view, the crucial fallacy of the widely hailed "new corporate governance culture" in the United States that it entirely ignores its gross macroeconomic deficiencies; from this perspective, the corporate frenzy for cost cutting and mergers and acquisitions is a grave error, because for businesses in the aggregate, they reduce rather than increase common revenues.

THE KEY DIFFERENCE TO EUROLAND

Back to the question of what explains the protracted, substantial difference in the growth performance between the English-speaking countries and the eurozone. Like Mr. Wolf, the consensus in these countries assumes better fundamentals and superior policies on the part of these countries. "Superior flexibility" is the favored catchphrase.

For us, the key difference between the English-speaking economies and that of the eurozone economy is strikingly obvious. Forget about better fundamentals, new paradigm, productivity growth and other bombastic assertions; the Anglo-Saxon countries owe their superior growth performance over the last few years to one overriding cause: unprecedented and unsustainable consumer profligacy manifestly reflected in a commom collapse of saving.

Comparing the rate of U.S. real GDP growth since 2000 to that of Euroland, the U.S. policies of recent years appear highly successful. But compared to U.S. recoveries in the past, the result is extremely disappointing. By this measure, the policies have grossly failed.

But why? That is, of course, the all-important question. Our short answer is that these policies have dismally failed because they produced a pattern of growth that completely lacks normal growth dynamics — that is, strong investment growth generating solid employment and income growth. Emphasis is on pattern of growth. Unfortunately, this is precisely what policymakers and most economists in America completely ignore.

What developed was a "bubble economy" where artificially low interest rates have been propelling an unusual rise in stock and house prices. By providing households with ballooning collateral for borrowing, these promptly embarked an unprecedented borrowing and spending binge on consumption.

The economic development in the English-speaking countries over the last few years shows four common hallmarks: *first*, ballooning consumer indebtedness; *second*, collapsing personal saving; *third*, consumption taking a sharply growing share of GDP; and *fourth*, with the exception of Canada, a sharply rising trade deficit.

None of these features are found in the Euroland economy. The consumer sector is running a savings surplus, even including house financing. Consumer indebtedness since 2000 has edged up from 80% to 85% of disposable income. The nonfinancial business sector is in deficit equal to about 1% of GDP. The collective budget deficit has stagnated since 2000 close to 3% of GDP. The net result is a permanent trade surplus.

Moreover, there was zero fiscal stimulus and minimal monetary stimulus in Euroland. According to conventional thinking in the Anglo-Saxon countries, this was the great mistake of the European authorities. Manifestly, Europe refused to follow the American example. But why? That is another crucial question. The fact is that based on disappointing experience in past decades, policymakers in Europe hold a very low esteem for massive monetary and fiscal stimulation. We share this view. By no means is it only the Maastricht Treaty that has prevented larger deficit spending by governments.

Assessing the U.S. economy's performance in light of the massive monetary and fiscal stimulus, we find these scruples fully justified. Keep in mind: America's recovery since 2001 is the weakest since the 1930s. What is more, these profligate short-run policies have dramatically destabilized and weakened the U.S. economy in the long run.

Let us take a look at U.S. real GDP growth since 2000. Real GDP is up 10.9%. Over the same time, its main components have risen as follows: consumer spending, 13.8%; therein, durables, 29.5%; residential building, 26.6%; government spending, 13.2%; imports, 16.2%; and exports, 3.2%. In contrast, business fixed investment barely exceeds its 2000 level. Capital investment in structures has plunged 24%.

For the bullish consensus, the proof of the success of these policies is in the mildness of the 2001 recession and in the strength of the post-recession recovery compared to Europe and Japan. This is systematic disinformation. True, the recession was milder than usual. But that has been negatively counter-balanced many times by the unusually weak recovery in the following three years.

POLICY FAILURE

By any measure, the U.S. economy's recovery after the recession of 2001 is by far the weakest since the Great Depression. That is one reason for our great wariness about its sustainability. There are others.

The second main reason is that the massive monetary and fiscal stimulus of the past three years has flatly missed its most important objective. This was to launch a self-sustaining recovery, with solid increases in payrolls, taking over from consumer spending as the driver of economic growth. It has not happened.

With all its policy stimulus, the U.S. economy's employment performance since 2000 is by far the worst in the whole world, far worse than in Euroland, where employment has been growing. The following numbers show the disappointing development of real disposable income. In fact, they reveal a complete policy failure in this crucial respect:

U.S. GROWTH OF DISPOSABLE PERSONAL INCOME IN % (IN CHAINED DOLLARS, ANNUALIZED)

1999	2000	2001	2002	2003	Q1 04	Q2 04	Q3 04
3.0	4.8	1.9	3.1	2.3	2.4	2.8	2.0

GROWTH OF GDP IN % (IN CHAINED DOLLARS, ANNUALIZED)

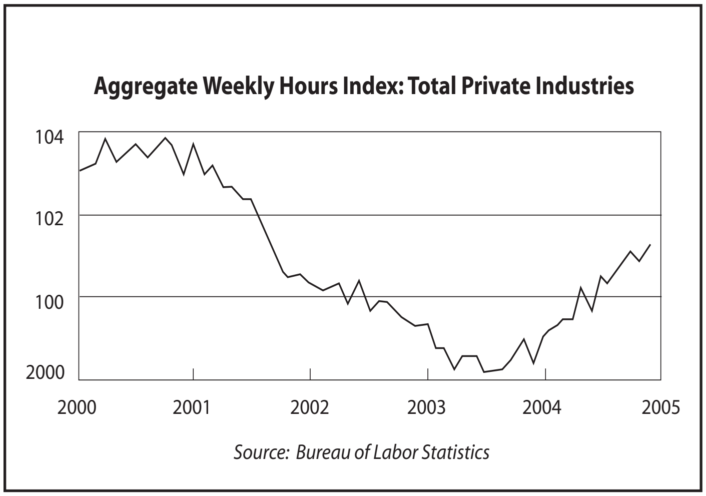
1999	2000	2001	2002	2003	Q1 04	Q2 04	Q3 04
4.5	3.7	0.8	1.9	3.0	4.5	3.3	4.0

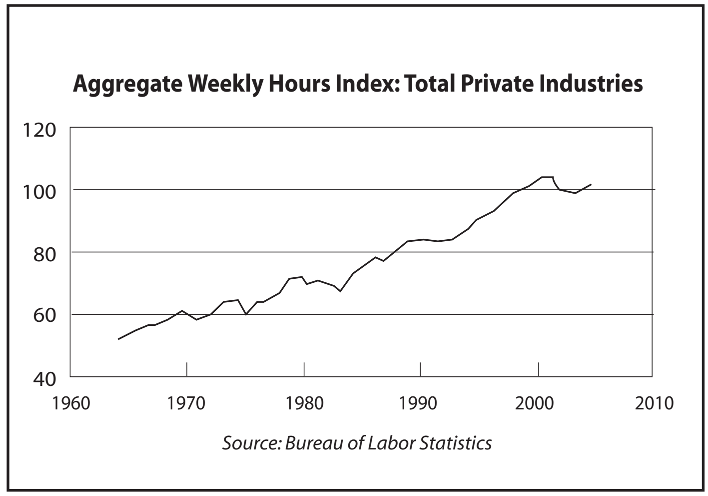
SOURCE: BUREAU OF ECONOMIC ANALYSIS, U.S. DEPARTMENT OF COMMERCE

The recent poor development of real disposable income reflects mainly three things: the end of tax cuts, rising inflation and unusually poor employment growth. We regard the latter as the decisive failure.

The fact is that since 2000, average weekly earnings in real terms have virtually stagnated. Taking the sharp decline in employment over this period into account, the reason for the reckless consumer borrowing becomes evident: Living standards would be sharply falling otherwise.

Stating these numbers, we ought to recall our major reservations about U.S. statistics. We regard the reported U.S. inflation rates, compared to Europe, understated by at least one percentage point, implying correspondingly overstated GDP and productivity growth. And so are, in our view, the employment numbers. More than half of their





growth in 2004 came from the net birth/death ratio, supposedly capturing employment growth among new firms.

New firms, to be sure, represent a minimal fraction compared to the mass of existing firms. It is an absolutely ridiculous assumption that under the present unfavorable economic conditions new firms are creating more new jobs than the whole existing economy.

To convey, apparently, the impression of precision, the Bureau of Labor Statistics claims to calculate these numbers with a computer model. But the computer model reflects nothing but the highly arbitrary assumptions that the BLS is putting into it. Speaking of a computer model is plainly part of a systematic deception. Of the reported increase of 157,000 in employment during November, virtually one half, 78,000, came from the net birth/death ratio.

SPOTTING AN ASSET BUBBLE

In August 1999, Mr. Greenspan, in a speech to central bankers in Jackson Hole, Wyo., made the famous remark, *"To anticipate a bubble about to burst requires the forecast of a plunge in the prices of assets previously set by the judgment of millions of investors, many of whom are highly knowledgeable about the prospects for the specific investments that make up our broad price indexes of stocks and other assets."*

It is, first of all, the wrong question to ask. The paramount task concerning an asset bubble is not to "anticipate its burst," but to recognize its emergence and to decide what to do as central bank or investor. The most important present case is, of course, the inflation of house prices in many countries.

As to the U.S. economy, it is crucially important to realize in the first place that in the absence of any domestic savings, the whole financial system is exclusively built on highly leveraged carry trade. In his **Theory of Interest,** ***professor Irving Fisher, famous from the 1920–30s, makes a statement that used to be a truism among economists: "Capital value is increased by savings." In today's United States, carry trade determines capital value.***

The point is that in a balanced economy, the purchasing power for assets essentially comes from one source: savings out of current income. Therefore, we keep asking ourselves where all the money for the bullish markets is coming from in a country without savings. The near-zero U.S. household savings rate is, in fact, materially overstated. Disposable personal income, according to the Bureau of Economic Analysis (BEA), includes close to $900 billion in "imputed income."

"Imputations" are part of the GDP or national income in which the statisticians imagine the creation of value involves no cash payments. The largest component of this kind is imputed rent for owner-occupied housing. Another considerable item in this category is "services furnished without payment by financial intermediaries." The general

use of free checking accounts is a reason for the BLS to treat this as "imputed income" for private households.

According to the published national income reports, private households in the last few months saved on average barely 0.3% of their disposable income. But this includes more than $400 billion "imputed" savings from more than $900 billion in "imputed" disposable income. Counting only cash savings from cash income, an average American household has a negative savings rate of about minus 4% of disposable income.

U.S. BOND MARKET — A POWDER KEG

Reading the U.S. economic and financial numbers, two questions are uppermost in our mind: *First*, how has all this been possible? And *second*, how will it end?

Our nightmare, frankly speaking, is the asset bubbles — in bonds, stocks and housing — and the permanent, rampant credit expansion needed to sustain their further price inflation. As pointed out, an economy without savings needs uninterrupted massive new leverage to prevent a rise of market rates.

The greatest recent surprise about the U.S. economy for us is the stability of longer-term interest rates defying rampant credit expansion, the Fed's rate hikes and a pretty sharp rise of consumer price inflation in 2004. At the same time, risk spreads have contracted to historical lows. Issuance of high-yield junk bonds last year reached a new all-time high of $139 billion.

For us, there is one compelling explanation: a last, wild rush of financial institutions and hedge funds into highly leveraged carry trade of bonds. Preventing a rise in longer-term market rates in the face of a runaway credit expansion requires ever more carry trade.

The Fed has raised the costs of carry trade and trumpets its determination to carry on. While interest rate spreads have shrunk as a result, they remain attractive for bonds with maturities from five years (3.72%) to 10 years (4.2%). The shrinking risk spreads, in particular, plainly suggest a growing willingness to maintain profits by taking higher risks in junk.

Rising long-term yields could, of course, increase the necessary spread. But if they do, the whole carry trade game would immediately be up, because higher bond yields, meaning lower bond prices, would wipe out capital with the same high leverage as their decline had boosted capital gains. With this in mind, we regard the U.S. bond market akin to a powder keg.

According to recent public remarks of Fed officials, they remain on course for further "measured" rate hikes in the months ahead. Members of the FOMC declare that the economy will continue to grow at a rate slightly above its potential growth rate. The futures market is pricing in consecutive 25 basis point rate hikes at all FOMC meetings through the summer, with the funds rate reaching 3.5% by August.

Compared to past experience and a current inflation rate of around 3.5%, this seems anything but tight. But the overriding risk is in the carry trade bond market. With a fed funds rate of 3.5%, the underlying yield spreads would shrink to razor-thin margins, forcing the highly leveraged bond holders to unwind their positions that are many, many times larger than those of Long-Term Capital Management in September 1998.

ALL-AROUND DENIAL IS TRUMPS

With this in mind, it seems glaringly evident to us that a fed funds rate of 3.5% would shatter not only the bond bubble, but with it the whole U.S. financial system, being built entirely on highly leveraged carry trade exploiting the yield curve.

If the Fed, indeed, sticks to rate hikes toward this level, this calamitous outcome appears inevitable. Therefore,

it greatly puzzles us that nobody seems to worry in the least about this danger, neither the Fed nor the people in the financial system.

The general comforting argument is the U.S. economy's famous resilience. Compared to past experience and also to the present inflation rate of 3.5%, a fed funds rate of the same level does, indeed, appear unusually low. Yes, but with its extensive bubble system running into trillions of dollars, the U.S. economy has acquired a most dangerous Achilles' heel. In the late 1970s, Paul Volcker pushed the fed funds rate to 20%. It hurt, but the financial system weathered it without great damage. This time, a 3.5% fed funds rate is able to jeopardize the whole U.S. financial system.

Seeking an explanation for the prevailing complacency, we come back to our remarks about the eclipse of macroeconomic thinking in the United States. In its rigorous absence, macroeconomic problems are implicitly non-existent.

False euphoria about the asset markets in the United States has its counterpart in false euphoria about the economy and its asset markets. Persistent strong economic growth with low inflation is a key assumption behind the Fed's rate hikes and also behind the extraordinary bullishness in the asset markets.

MANUFACTURING IN DEPRESSION

Our great worries about the U.S. economy have two main reasons. One is the horrendously unsustainable leverage in the financial system, and the other is the economy's extremely lopsided pattern of recovery. Among the worst features is the virtual massacre of the manufacturing sector.

For sure, faster growth in health services or retail trade is no substitute. Manufacturing is the sector where, in actual fact, the whole employment decline has centered. Considering that this sector has lost 3 million jobs since 2000, from 17 million to 14 million, it is certainly no exaggeration to speak of depression.

American policymakers and economists generally dispute that manufacturing plays a singularly important role in our economies. The fact is that it is vital for two factors of overriding importance for economic growth: *first*, the trade balance; and *second*, the investment level in the economy. Manufacturing, including utilities, stands out as the sector with the highest gross investment ratio.

What about the trumpeted excellent U.S. profit performance during the last two years? Yes, there was a steep rise from the extreme lows in Q4 2001. Yet here, too, the devil is in the details, in a longer-term perspective. To capture an underlying trend, we focus on three aggregates and four different data. The aggregates are total nonfinancial profits, and therein the components of manufacturing and retail trade:

PROFITS (IN $ BILLION)

	1997	2000	2001	Q3 04 (ANNUALIZED)
NONFINANCIAL PROFITS	508.4	409.8	322.0	468.7
MANUFACTURING	209.0	166.3	52.6	105.0
RETAIL TRADE	59.6	77.7	71.0	64.7

SOURCE: BEA NATIONAL ECONOMIC ACCOUNTS

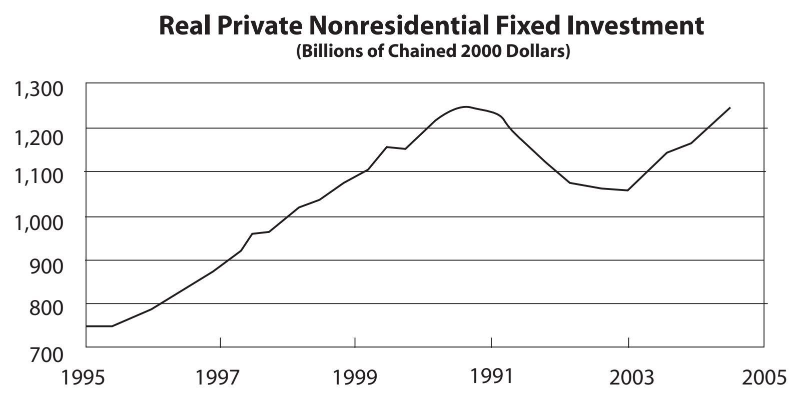
What to make of these numbers? Manufacturing profits are a plain disaster. But looking at nonfinancial profits as a whole, the decline since 1997 appears moderate. Yes, but there are seven years between them during which the U.S. GDP has risen 20% in current dollars. Measured against GDP, nonfinancial profits are down 36% since 1997. As an aside, in 2003 — later data are not available — undistributed profits in the manufacturing sector were negative $62 billion and in the information sector negative $25.7 billion. In other words, both sectors are largely paying their dividends with borrowed money.

BUSINESS IS RISK AVERSE

From our macroeconomic analysis, it appears manifest that further strong U.S. economic growth depends crucially on the comeback of sustained strong business fixed investment. Looking at the following chart, covering business fixed investment over the last 10 years, it appears, however, that since 2000, there has been a distinct break in the trend of business nonresidential fixed investment. It seems a reasonable assumption that this is also responsible for the poor employment and income performance over these years.

The consensus in the United States is optimistic that the strong revival of business fixed investment and employment is just around the corner. It is, in fact, the key question about the U.S. economy. The major arguments are strong corporate balance sheets and positive profit prospects.

Corporate cash holdings are, indeed, at record levels. Typically, businesses borrow to finance capital investment in excess of their depreciations. But since the second quarter of 2003, something most unusual has been happening. For the first time since World War II, U.S. businesses are running financial surpluses.



Source: Bureau of Economic Anaysis

Ominously, this is happening at a time of record-low real interest rates and very high stock valuations, measured by prevailing price-to-earnings ratios. By both measures, capital costs are at their lowest in the postwar period. Yet business fixed investment remains far weaker than in any prior recession.

The one reasonable explanation we can think of is that corporate managers regard the expected possible returns on new investment as unsatisfactory. On the other hand, however, these same managers are using soaring sums for mergers, acquisitions and stock buybacks. Plainly, deal-making and stock-price manipulation is preferred over expansion through new investment.

A DISMAL PROFIT OUTLOOK

It is generally agreed that actual and expected profits are the single most important influence on the decision of corporate managers to invest and to hire. Here again, though, we must emphasize that the devil is in the details.

Over the last few years, reports about soaring U.S. business profits made headlines in the media. In total, it was their steepest increase in the National Income and Product Accounts (NIPA) in the entire postwar period. However, the total was heavily bolstered by huge financial profits, and moreover, there was an extremely mixed development between different sectors of the economy.

As pointed out, the profit performance of firms in the nonfinancial sector in the aggregate has been distinctly poor in the longer run, measured from 1997. Beyond question, this sector has preponderant importance for economic growth. It is the sector where all economic activity takes place, in contrast to financial activity.

Corporate America's superior profitability has always been a myth. Assessing the poor profit development from the macro perspective, this has one obvious reason. That is the explosion of the U.S. trade deficit, from $136 billion in 1997 to around $650 billion recently. Apparently, U.S. policymakers and economists have yet to learn that this deficit is the economy's devouring profit killer.

The trade deficit means a corresponding net outflow of domestic spending to foreign producers, implicitly at the

expense of domestic producers. What is more, a large part of the money spent for the import surplus comes from the wage bill of U.S. firms, meaning huge expenses for them without revenue. Together, they suffice to shatter U.S. corporate profits.

A second major cause of poor corprate profitability in the United States since 2000 is the slump of net fixed investment, being the difference between gross investment and depreciations. In a healthy economy, this component is typically the business sector's most important corporate profit source.

The crucial point from the macro perspective is that investment expenditures, being capitalized, do not involve expenses until the gradual depreciation charges set in. On the other hand, they create revenue and income through the production of capital goods.

In short, both the soaring trade deficit and lower business investment have been the major negative influences on U.S. business profits over the past few years. What actually prevented their disastrous decline were the government's soaring budget deficit and the consumer borrowing and spending binge, flooding the business sector with money. Their growth, however, has passed its peak, while improvements in the trade deficit and investment spending appear more than doubtful. Under these conditions, profits will at best erode and at worst slide.

CONCLUSIONS:

Unfettered bubble-driven consumer borrowing has been the main engine of U.S. economic growth. Whatever apparent strength remains depends entirely on the housing and mortgage refinancing bubbles. But both have passed their peak.

Expressing fears of rising inflation and of "excessive risk-taking" in the financial markets, the Federal Reserve has announced a sequence of rate hikes. Put bluntly, they have become afraid of the ever-inflating credit and asset bubbles they have unleashed with their ultra-low interest rates. "Measured" rate hikes are, in essence, a belated attempt to let the air gradually out of the monstrous asset and credit bubbles.

Given the preposterous leverage underlying all U.S. asset markets, the Fed is running an immense risk of bursting the asset and credit bubbles with a bang. The second major risk we see is that an unexpected sharp slowing of the U.S. economy will shake the prevailing complacency, with dire consequences for the economy and its financial system.

But what will happen to U.S. economic growth and its financial system without inflating bubbles? It is like pulling the rug out from under them.

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